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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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October 27, 1993

VIA HAND DELIVERY

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: Ex Parte Presentation in MM Dockets 92-266, 93-215

Dear Mr. Caton:

Pursuant to 47 C.F.R. § 1.1206, Miller & Holbrooke submits this original and one copy of a letter disclosing a written and oral ex parte presentation.

On October 26, 1993, Jane E. Lawton, Robert P. Hunnicutt, Nicholas P. Miller, and Joseph Van Eaton met on behalf of Montgomery County, Maryland, with Jay Atkinson, Jennifer Manner, Jonathan Levy, and Larry Walke.

The meeting dealt with the treatment of excess acquisition costs under cost of service; pass-through of upgrade and franchise-related costs; and voluntary agreements affecting rates. Attached are two additional copies of written ex parte comments which were given to the FCC attendees listed above and filed with the Secretary on October 27.

Very truly yours,

MILLER & HOLBROOKE

By


Nicholas P. Miller

Enclosures
cc: Jay Atkinson
0133\cos-exp.net

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY




Montgomery County Government
ROCKVILLE, MARYLAND 20850

MEMORANDUM

October 18, 1993

TO: Marilyn Praisner, President, Montgomery County Council

FROM: Neal Potter, County Executive 

SUBJECT: Transfer of the Cable Television Franchise

I am pleased to transmit to the Council for its consideration, my recommendation to approve the transfer of our cable television franchise from Montgomery Cablevision Limited Partnership (MCLP) to Southwestern Bell Corporation's (SBC) subsidiary, SBC-Media Ventures Inc. (SBC-MV).

Our staff has conducted a very thorough review of several volumes of SBC and MCLP filings. In addition, our Cable Communications Advisory Committee sponsored a public forum to discuss issues related to the transfer and a public hearing was held on July 29, 1993. I conclude that based on the documents submitted by all interested parties and the attached Executive Report, I am satisfied that my concerns regarding the effect of the transfer on our cable subscribers and the County have been resolved.

As you know, from the beginning, my primary concern has been with the impact of the transfer on subscriber rates and services. Additionally, our review process has been complicated by the rapidly changing cable regulatory environment and federal approvals necessary to satisfactorily complete this transfer. These issues have been resolved. I believe that the Settlement Agreement which is attached with this recommendation adequately protects subscriber rates from possible adverse impact due to the transfer and affords us an opportunity to take advantage of new services as they may be offered by SBC-MV.

Southwestern Bell is an outstanding company and its presence in our community provides an excellent opportunity for the County, our cable subscribers, and the citizens we represent, to fully realize the benefits of the rapidly advancing technology in the field of telecommunications. I look forward to establishing a good working relationship with SBC-MV in providing advanced cable television and telecommunications services from which we all will benefit.

My staff and I are at your disposal should you need any assistance in your review process.

NP:JEL:rph
attachments

**EXECUTIVE REPORT TO COUNTY COUNCIL REGARDING:
PROPOSED CABLE FRANCHISE TRANSFER TO SBC-MEDIA VENTURES**

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October 18, 1993

**EXECUTIVE REPORT TO COUNTY COUNCIL REGARDING:
PROPOSED CABLE FRANCHISE TRANSFER TO SBC-MEDIA VENTURES**

I. Background

A. Status of the Transfer Review Process

In 1986, Montgomery Cablevision Limited Partnership, Inc. ("MCLP") entered into a franchise agreement with the County to provide cable services to County residents, succeeding to the franchise originally granted in 1983 to Tribune-United Cable of Montgomery County ("Tribune-United"). On February 5, 1993, Southwestern Bell Corporation ("SBC") and SBC Media Ventures, Inc. ("SBC-MV") signed an Asset Purchase Agreement to acquire the system serving the County from MCLP. SBC-MV formally requested the transfer of the cable franchise issued by the County in a letter dated March 31, 1993, submitted to the County with certain supporting information on April 2, 1993 ("April 2 Package").

The County Executive has conducted a careful review to determine whether the County should approve the proposed transfer. To assist it in evaluating SBC-MV's proposal, the County retained Miller & Holbrooke, a Washington, D.C. communications law firm. Transcomm, Inc., a financial consulting firm, was retained by Miller & Holbrooke to analyze the financial information submitted by the companies.

After reviewing the documents initially provided by SBC-MV, the County requested additional information to clarify issues raised by the proposed transfer. Information not considered confidential by MCLP and SBC-MV was made available for public inspection. A public forum was held by the Cable Communications Advisory Committee ("CCAC") on June 21, 1993, and CCAC recommended approval of the transfer, with certain reservations, on July 29, 1993. The County conducted a public hearing regarding the transfer on July 29, 1993. In addition, Columbia Telecommunications Corp. (CTC), the County's engineering consultants, along with County staff inspected cable systems owned and operated by SBC in the United Kingdom.

The County has discussed the transfer extensively with both MCLP and SBC-MV. Subject to the approval of the transfer by the County Council, the County Executive, MCLP, SBC, and SBC-MV have entered into an agreement ("Settlement Agreement") to resolve issues raised by the transfer.

B. Summary of Proposed Transaction

SBC Media Ventures, Incorporated ("SBC-MV") proposes to

purchase the Montgomery County cable system (including the portion of the system serving the City of Gaithersburg, which is governed by a separate franchise) from Montgomery Cablevision Limited Partnership ("MCLP"), owner of the system that serves County residents under the name Cable TV Montgomery ("CTM"). At the same time, SBC-MV seeks to acquire the system serving Arlington County, Virginia from Arlington Cable Partners which is under common ownership with MCLP. The total purchase price for both systems is \$650 million, or \$2,889 per subscriber. Of this amount, the Arlington County system accounts for \$116 million, or approximately \$2,237 per subscriber. The purchase price for the Montgomery County system alone is \$534 million, or \$2,975 per subscriber. Each figure is subject to adjustment, as specified in the Asset Purchase Agreement between MCLP, SBC-MV, and SBC, based on conditions obtaining at the time of closing.

In its proposal and subsequent discussions, SBC-MV has stated that it has no specific present plans to make any material changes with respect to geographic area served, physical facility proposed, construction plans, or services to be provided after the transfer. However, it is reasonable to expect that SBC-MV may, at some time in the future, integrate advanced telecommunications services with the cable system. SBC-MV's interest in such services is evident from its provision of non-cable services together with cable services on its cable systems in Great Britain. (See CTC summary in Attachment 1.) If SBC-MV were to rebuild the County's cable network along the lines of the British system, the network would become able to provide voice telephone services and other non-cable services such as business private line and long distance connections and data communications. Moreover, if the cable system's architecture is converted to a fiber optic distribution network, it is suitable for implementing cellular service and/or Personal Communications Services ("PCS") (advanced cellular services). Presumably, SBC-MV would consider offering these types of services in the future if economically profitable and legally permissible. The current involvement of Southwestern Bell Corporation ("SBC") in cellular telephony in the Washington area through its Cellular One subsidiary suggests a broader business interest than simple one-way video entertainment services.

SBC-MV has not committed itself to any specific improvements in the County's system. However, it has stated in the application materials and in discussions with County staff that the company will introduce new services when and if they become technically feasible and cost effective. Subsequently, in response to inquiries by County staff, SBC-MV stated that it expects to upgrade the cable TV system in 2-5 years through gradual conversion to fiber optics and compression technology, providing improved picture quality, more channels, and more service options such as near-video-on-demand. SBC-MV's longer-term expectations include providing interactive services in 5-7

years and telephone service in 7-10 years. At the County's request, SBC-MV described these goals further in an August, 1993, document entitled SBC's Vision For Cable In Montgomery County. See Attachment 2.

II. The Settlement Agreement Resolves Serious Concerns Raised by the Proposed Transfer.

The transfer of the County's cable system, as originally proposed, raised a number of serious concerns. The gravest of these concerns was that County residents would bear the risk of having to pay substantially higher cable rates than MCLP would have been able to charge if the transfer were not approved. Consequently, the County has entered into a Settlement Agreement with SBC-MV which provides that over the next three years, County subscribers will be protected from the risk that the total rates charged for regulated basic and cable programming service tiers will exceed Benchmark rates as a result of the purchase price of the proposed transaction. See Attachment 3.

Similarly, the proposed transfer did not initially address needed improvements to the County's institutional network ("G-Net"), or County access to potential new services. However, MCLP has agreed to provide the County with funds for system improvements which will assure that the G-Net as maintained by SBC-MV will meet technical specifications and provide reliable service. SBC-MV has acknowledged its continuing responsibility to fulfill all G-Net obligations of the franchise. Id.

The County has determined that any disadvantages attributable to the size and corporate structure of SBC-MV, such as less accessible management than with MCLP, are outweighed by SBC-MV's considerable financial and technical resources, as well as SBC-MV's extensive experience in the telecommunications field generally.

A. Rates

The transfer as originally proposed could have resulted in higher cable rates than would otherwise have been permitted, solely because of the excess acquisition costs of the sale. This problem stems from the current regulatory environment created by the Cable Television Consumer Protection and Competition Act of 1992 ("1992 Cable Act") and the implementing regulations issued by the Federal Communications Commission ("FCC"). Therefore, the County and SBC-MV have agreed to terms designed to prevent the excess acquisition costs of the system from resulting in higher subscriber rates. See Attachment 3.

1. Rate Regulation Under the 1992 Cable Act

Cable rates have passed through two legal stages and have just entered a third. Prior to 1984, rates were subject to regulation by local franchising authorities according to standards set by each local government. With the passage of the Cable Communications Policy Act of 1984, 47 U.S.C. §§ 521 et seq. ("1984 Cable Act"), rates were deregulated. Except in a very few cases, local governments were pre-empted by federal law from controlling cable rates despite the fact that most cable systems were de facto economic monopolies, unrestrained by competitive market forces. Hence, during the period of deregulation, cable rates rose much faster than the general national rate of inflation. In response, Congress enacted a new rate regulatory regime in the 1992 Cable Act. Rather than return full regulatory powers to local governments, Congress instructed the FCC to construct a single nationwide method for rate regulation, with implementation to be a responsibility shared between the FCC and local governments. The FCC began crafting this new rate regulatory process in the spring of 1993. See Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket 92-266, Report and Order and Further Notice of Proposed Rulemaking (May 3, 1993) (as subsequently amended) ("Report and Order").

Under this new process, where a cable operator is not subject to effective competition, basic cable service and equipment rates are regulated by franchising authorities in accordance with a methodology defined by federal rules. Other cable service tier rates are regulated by the FCC itself, using the same methodology. Rates for non-tiered services such as premium channels and pay-per-view are not generally subject to rate regulation.

Under the rules established by the FCC, the cable operator is permitted to select one of two methods of rate regulation: benchmark or cost-of-service. Rates based on the benchmark methodology will be determined by using existing rates compared to nationwide standards as calculated by the FCC. The relevant standards are selected based on the number of system subscribers and the number and type (local or satellite-delivered) of channels provided. Rates defined by benchmark methodology are not affected by who owns the system, or by the cost of purchasing or operating the system.

Under cost-of-service regulation, however, cable service rates will depend on the individual cable operator's investment and operational costs. In other words, a change in operators may directly affect subscriber rates. Under traditional utility cost-of-service rate regulation, one factor involved in determining subscriber rates is the value of the system. That value is usually a business investment expense recoverable in

whole or in part from subscriber rates. In other words, it is reflected in the cost-of-service rate base -- the amount that the cable operator may recover, plus a reasonable profit. To the extent that different owners have different values for a cable system allowed in the rate base, a change in ownership may make a drastic difference in the rates allowable under the cost-of-service method.

2. Rates under MCLP's Ownership

Montgomery County's cable rates are already among the highest in the area. See Attachment 4. Application of the benchmark method of rate regulation is expected to reduce these rates. On the basis of the maximum permitted rates provided to the County by MCLP in September, 1993, the County's staff and financial consultants calculated that the benchmark method should provide an average rate rollback of approximately \$4.91 per month per MCLP subscriber. See Attachment 5. The best evidence available at the end of September thus suggests that the rates for services and equipment in effect as of September 1, 1993, would be significantly reduced by application of the FCC's benchmark method of rate regulation.

3. Rates under SBC-MV's Ownership

Under the benchmark method, the rates permitted for SBC-MV would be almost identical to those permitted for MCLP. However, under the cost-of-service method, the purchase price paid by SBC-MV could make a substantial difference in the permissible rates depending on the final rules adopted by the FCC.

Under traditional utility rate methodology, a cable system's value would normally be based upon the actual cost of constructing the plant and system facilities, less depreciation. A later sale of the system to a new investor at a price higher than the book value of the system would not be added to the rate base. System buyers often pay a premium over costs, based primarily on the expectation of future profits. Such a premium is referred to as "excess acquisition costs" in rate regulatory proceedings. This premium is beneficial only to the system's seller, because it does not contribute to the quality or type of services offered to customers. Consequently, such a premium is normally excluded from the allowable rate base subject to subscriber rates. See Attachment 6. The Maryland Public Service Commission, for example, does not consider excess acquisition costs to be "used or useful" to a utility's consumer. It normally prohibits a telephone, electric or other company from passing these excess costs on to subscribers. Instead, it requires the shareholders to absorb these costs, on the grounds that investment risks should be borne by the investors who would

receive any profits, not by customers who would not.

If, however, excess acquisition costs were allowed in the rate base, the resulting burden upon subscribers could be substantial. SBC-MV proposes to pay \$534 million to acquire the MCLP system. According to the County's financial consultants, this price consists of \$105 million for the system's net book value, plus \$429 million as an acquisition premium -- the excess of the purchase price over the value of the acquired assets. Inclusion of excess acquisition costs in the rate base could permit SBC-MV to charge the average County subscriber almost \$32 a month more, or a total of \$383, above current rates in 1994 alone. The system's transfer as proposed could thus cost the County's 163,226 subscribers approximately \$801,440 more per month, which amounts to \$48 million more over the five years remaining in the franchise. See Attachment 5.

Therefore, it is of the utmost importance to County subscribers whether SBC-MV is permitted to include excess acquisition costs in cost-of-service rate base calculations. If excess acquisition costs were allowed, then rates could increase greatly over those allowed under the benchmark method. If even partial excess acquisition costs were included, approval of the transfer could force County subscribers, in effect, to assume part of SBC-MV's financial risk through potentially higher rates.

4. Status of the FCC's Cost-of-Service Rules

The FCC plans to issue cost-of-service guidelines that will determine, among other things, which costs may be included in the cable rate base. However, it has not yet established those guidelines. On July 16, 1993, the FCC released its Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket 93-215, Notice of Proposed Rulemaking (July 16, 1993) ("Cost-of-Service NPRM"). Comments were filed by interested parties on August 25, 1993, and reply comments filed on September 14, 1993. It is unclear when the FCC will issue its final rules.

In the Cost-of-Service NPRM, the FCC tentatively proposed that it would exclude excess acquisition costs from the rate base, just as in the telephone industry. However, the Commission also suggested potential alternatives that would allow excess acquisition costs to be recovered, in whole or in part, from subscribers. Thus, for example, the FCC suggested that it might allow some excess acquisition costs, such as customer lists or franchise rights, to be included in the rate base, or allow cable operators to amortize such expenditures as recoverable operating expenses. The FCC also stated that it might allow partial recovery of excess acquisition costs in view of the industry's

transition from a nonregulated to a regulated environment. See Cost-of-Service NPRM at ¶¶ 36-41.

Cable industry groups have heavily lobbied the Commission, arguing that excess acquisition costs should be included in the cost-of-service rate base. Franchising authorities, including the County, have argued and continue to argue before the FCC that such costs should not be included. If these costs are permitted by the FCC in cost-of-service showings, SBC-MV could be able to justify much higher cable rates, as a result of the transfer price, than it could charge under the benchmark method of regulation. In other words, if excess acquisition costs could be included in the rate base, then SBC-MV could use a cost-of-service showing to attempt to avoid the rate rollbacks that would be mandated by the FCC under the benchmark method, and could seek still higher rates.

5. The Settlement Agreement Resolves Excess Acquisition Cost Concerns

Congress intended the Cable Television Consumer Protection and Competition Act of 1992 ("1992 Cable Act") to result in lower, not higher, rates. A transaction creating a serious risk that County residents would lose the possibility of rate reductions intended by that legislation would not be acceptable. The parties to the transfer, as well as the County, wish to conclude the transfer because of the uncertainty of the federal regulatory atmosphere concerning rates. Accordingly, the County has negotiated the Settlement Agreement with SBC-MV so that SBC-MV can complete its purchase of the MCLP system without depriving subscribers of the benefit of the benchmark rates established by the FCC.

SBC-MV has agreed that if it chooses to file a cost-of-service showing within the next three years, it will charge a combined rate for the regulated tiers no greater than MCLP could have charged had the transfer not taken place. In addition, SBC-MV has agreed that no costs associated with this agreement or specified in the Settlement Agreement will be passed through to subscribers. These costs will not be itemized on subscriber bills, reflected in MCLP's Final Balance Sheet or in any accounting statements of SBC-MV related to establishing cable system subscriber or user charges, or attributed to the capital costs or operating expenses of the cable system serving Montgomery County. See Attachment 3. Thus neither the transfer price, nor the benefits provided by the companies pursuant to the Settlement Agreement, should affect subscriber rates.

Since the County and SBC-MV have agreed to exclude excess acquisition costs in cost-of-service showings, the risk of substantially higher subscriber rates has been eliminated for at

least the next three years. As a result, the County has determined that the risks due to excess acquisition costs have decreased significantly, given the protections for subscribers embodied in the Settlement Agreement.

6. SBC-MV's Financial Projections

The pro forma financial projections supplied by SBC-MV with its initial request for transfer included cost-of-living increases of 3.5% per year. These increases, however, were based on then-current, unregulated rates, which did not reflect the rate rollbacks the County now expects from the benchmark method. SBC-MV's original business plan, as reflected in these projections, was thus based on rates significantly higher than benchmark rates.

Calculations supplied by MCLP on October 1 appear to confirm that, as stated above, use of the benchmark method would result in sizable reductions in rates for County subscribers. In addition, on October 4, SBC-MV submitted newly revised pro forma projections. See Attachment 7. These projections indicate that SBC-MV should be able to accept benchmark rates and still operate the County's system on a profitable basis, particularly if SBC-MV moves quickly to develop new, unregulated services. This indicates that an agreement to maintain cable subscriber rates at MCLP's levels should be financially workable for SBC-MV.

B. Government Network

The current franchise requires MCLP to operate a government network ("G-Net") for the County. The County depends on this network to serve vital County needs on a day-to-day basis. However, the present G-Net faces two major problems: capacity and reliability. The G-Net is at the limit of its capacity for the County's present needs. Yet over the life of the MCLP franchise, for a variety of reasons, it has proven extremely difficult to maintain the G-Net's performance and maintain its technical specifications. Only after major maintenance this year did MCLP bring the government network into compliance with acceptable test parameters on July 29, 1993. The G-Net requires continuing efforts by the cable operator to maintain its proper operation.

To rebuild the G-Net with a newer technology, MCLP has agreed to provide the County with \$6.0 million dollars. The County's technical analysis indicates that this sum should be sufficient for the County's near-term needs.

C. New Services

SBC-MV has provided statements outlining new services that might, at some future time, be offered on a system under SBC-MV's control. SBC-MV has made it clear that it is making no commitments to any particular upgrade or improvement of the system at any time. However, the County anticipates that SBC-MV will move reasonably quickly to construct an upgraded fiber optic network in the County. See Attachment 2.

1. The Settlement Agreement Provides Guaranteed Access to Any New Facilities

If and when SBC-MV installs a fiber optic network, it has agreed to make available to the County, free of charge, transmission capacity on up to 300 linear plant miles of that network. The County will have the right to use up to ten percent of the transmission capacity, deployed on two fibers to a maximum of 4.8 gigabits per second at any point on the network. SBC-MV has agreed to consult and cooperate with the County on the timing and routing of such new facilities. SBC-MV will be responsible for construction, operation, network management and maintenance of the facilities interconnecting the SBC-MV network to locations designated by the County, at no cost to the County. These Settlement Agreement provisions concerning new services adequately compensate the County for the risks involved in the implementation of new technologies.

2. Effect of the Modification of Final Judgement

If and when SBC-MV wishes to offer advanced services, it must comply with restrictions contained in the Modification of Final Judgement ("MFJ"), the 1982 court decision governing the activities of the Regional Bell Operating Companies ("RBOCs") subsequent to the AT&T breakup. Among other things, the MFJ prohibits a RBOC, such as Southwestern Bell Corporation, or any of its subsidiaries, such as SBC-MV, from providing interexchange (long distance) services. If the transfer application is approved, SBC-MV will be involved in two types of interexchange services: (1) the reception of satellite signals at the cable's headend, and (2) the transmission of cable signals across a telephone local access transport area (LATA) boundary line that divides a small section of northwestern Montgomery County (lying in the "Hagerstown LATA") from the rest of the County (lying in the "Washington, D.C. LATA") for interexchange purposes.

Accordingly, SBC applied for a federal court waiver of the MFJ restriction on behalf of SBC-MV to allow it to take over MCLP's current service. SBC received this waiver from the Court on September 21, 1993. The waiver is specifically limited to

provision of traditional cable service. Other sorts of service, such as advanced two-way services or the services now provided on the G-Net, are not covered by the waiver. This means that if SBC-MV wished to provide a non-traditional cable service on the subscriber network in the Hagerstown LATA area, it would need to get an additional MFJ waiver from the court, since such service would extend outside the Washington, D.C. LATA to the Hagerstown LATA. SBC-MV would also need an additional waiver if the County wished to extend the G-Net into the Hagerstown LATA area. MCLP, in contrast, would not have to obtain such a waiver; it is not a telephone company and hence is not subject to the MFJ. The effect of this distinction is that SBC-MV may face some additional regulatory hurdles that MCLP would not, if and when it moves to offer advanced services on a network extending into the Hagerstown LATA.

D. Franchise fees

The Agreement granting a cable franchise to MCLP as modified on Nov. 14, 1986 ("Franchise Agreement"), and the County's Cable Communications Law, Montgomery County Code 1984, Chapter 8A ("Cable Communications Law"), require that MCLP pay a franchise fee of five percent, together with an access grant of 1.5 percent, on all gross revenues from the operation of the cable system within the franchise area. See Cable Communications Law, § 8A-12(a); Franchise Agreement §§ 37(A), 31(I)(E)(2)(a). This provision makes no distinction between traditional cable service and other types of services that might be offered over the cable system. Thus, in order to approve the transfer of the system, the County requires that SBC-MV acknowledge that franchise fees are due on all gross revenues derived from non-cable services as well as from cable service.

SBC-MV has stated in the Settlement Agreement that it accepts the applicable franchise fee provisions of the Franchise Agreement and the Cable Communications Law. Consequently, SBC-MV has agreed to pay a five percent franchise fee and a 1.5 percent access grant on all gross revenues of SBC-MV or of any affiliate, derived from the operation of the cable system within the franchise area insofar as such payments are consistent with the Franchise Agreement and the County Cable Communications Law, during the period of the franchise.

E. Differences in Experience and Management Accessibility

Even though SBC-MV has limited experience in cable, its extensive experience in the telephone industry indicates that it is able to efficiently and effectively run a telecommunications system. SBC's experience in the cable field in Great Britain provides support for this conclusion. The County Executive

believes that SBC's experience and resources will enable SBC-MV to provide the same high quality of service to the County's subscribers as it provides to its other customers.

SBC's large corporate structure may result in the County receiving less individual attention from SBC's management than it does from MCLP. However, the County will benefit from the depth of financial and technical resources available to SBC, which would not be available to MCLP.

III. The County Has Authority to Approve or Deny the Transfer.

Before MCLP can transfer to another party the franchise the County granted to MCLP, it must obtain the County's approval. The County has the right to approve or deny such a transfer based specifically on the terms of the County's Cable Communications Law and the franchise agreement between the County and MCLP. Neither the 1992 Cable Act, nor the FCC regulations promulgated thereunder, prevent the County from determining whether the proposed transfer is acceptable.

Section 8A-23(e) of the Cable Communications Law states:

Before approving transfer of a franchise, the County must consider the legal, financial, technical and character qualifications of the transferee to operate the system, and whether operation by the proposed franchisee will adversely affect the cable services to subscribers or otherwise be contrary to the public interest.

The County has the right and responsibility to protect the public interest by evaluating any proposed transfer according to these considerations.

The Franchise Agreement expressly incorporates by reference the requirements of the County's Cable Communications Law, as amended. Franchise Agreement at § 6. Thus, by its acceptance of the Franchise Agreement, MCLP has agreed to the County's right to approve or deny a transfer, as set forth in the Cable Communications Law. In addition, the Franchise Agreement requires that SBC-MV be bound by all the provisions, terms, conditions, obligations, and limitations of the existing franchise. Id. at § 16(D).

The 1992 Cable Act does not alter the fundamental authority of the County to approve or disapprove a transfer. The Cable Act places no conditions on the criteria a franchising authority may apply in determining whether to approve a proposed transfer. Nor does it grant the FCC any authority to limit those criteria.

receive any profits, not by customers who would not.

If, however, excess acquisition costs were allowed in the rate base, the resulting burden upon subscribers could be substantial. SBC-MV proposes to pay \$534 million to acquire the MCLP system. According to the County's financial consultants, this price consists of \$105 million for the system's net book value, plus \$429 million as an acquisition premium -- the excess of the purchase price over the value of the acquired assets. Inclusion of excess acquisition costs in the rate base could permit SBC-MV to charge the average County subscriber almost \$32 a month more, or a total of \$383, above current rates in 1994 alone. The system's transfer as proposed could thus cost the County's 163,226 subscribers approximately \$801,440 more per month, which amounts to \$48 million more over the five years remaining in the franchise. See Attachment 5.

Therefore, it is of the utmost importance to County subscribers whether SBC-MV is permitted to include excess acquisition costs in cost-of-service rate base calculations. If excess acquisition costs were allowed, then rates could increase greatly over those allowed under the benchmark method. If even partial excess acquisition costs were included, approval of the transfer could force County subscribers, in effect, to assume part of SBC-MV's financial risk through potentially higher rates.

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transition from a nonregulated to a regulated environment. See Cost-of-Service NPRM at ¶¶ 36-41.

Cable industry groups have heavily lobbied the Commission, arguing that excess acquisition costs should be included in the cost-of-service rate base. Franchising authorities, including the County, have argued and continue to argue before the FCC that such costs should not be included. If these costs are permitted by the FCC in cost-of-service showings, SBC-MV could be able to justify much higher cable rates, as a result of the transfer price, than it could charge under the benchmark method of regulation. In other words, if excess acquisition costs could be included in the rate base, then SBC-MV could use a cost-of-service showing to attempt to avoid the rate rollbacks that would be mandated by the FCC under the benchmark method, and could seek still higher rates.

5. The Settlement Agreement Resolves Excess Acquisition Cost Concerns

Congress intended the Cable Television Consumer Protection and Competition Act of 1992 ("1992 Cable Act") to result in lower, not higher, rates. A transaction creating a serious risk that County residents would lose the possibility of rate reductions intended by that legislation would not be acceptable. The parties to the transfer, as well as the County, wish to conclude the transfer because of the uncertainty of the federal regulatory atmosphere concerning rates. Accordingly, the County has negotiated the Settlement Agreement with SBC-MV so that SBC-MV can complete its purchase of the MCLP system without depriving subscribers of the benefit of the benchmark rates established by the FCC.

SBC-MV has agreed that if it chooses to file a cost-of-service showing within the next three years, it will charge a combined rate for the regulated tiers no greater than MCLP could have charged had the transfer not taken place. In addition, SBC-MV has agreed that no costs associated with this agreement or specified in the Settlement Agreement will be passed through to subscribers. These costs will not be itemized on subscriber bills, reflected in MCLP's Final Balance Sheet or in any accounting statements of SBC-MV related to establishing cable system subscriber or user charges, or attributed to the capital costs or operating expenses of the cable system serving Montgomery County. See Attachment 3. Thus neither the transfer price, nor the benefits provided by the companies pursuant to the Settlement Agreement, should affect subscriber rates.

Since the County and SBC-MV have agreed to exclude excess acquisition costs in cost-of-service showings, the risk of substantially higher subscriber rates has been eliminated for at

least the next three years. As a result, the County has determined that the risks due to excess acquisition costs have decreased significantly, given the protections for subscribers embodied in the Settlement Agreement.

6. SBC-MV's Financial Projections

The pro forma financial projections supplied by SBC-MV with its initial request for transfer included cost-of-living increases of 3.5% per year. These increases, however, were based on then-current, unregulated rates, which did not reflect the rate rollbacks the County now expects from the benchmark method. SBC-MV's original business plan, as reflected in these projections, was thus based on rates significantly higher than benchmark rates.

Calculations supplied by MCLP on October 1 appear to confirm that, as stated above, use of the benchmark method would result in sizable reductions in rates for County subscribers. In addition, on October 4, SBC-MV submitted newly revised pro forma projections. See Attachment 7. These projections indicate that SBC-MV should be able to accept benchmark rates and still operate the County's system on a profitable basis, particularly if SBC-MV moves quickly to develop new, unregulated services. This indicates that an agreement to maintain cable subscriber rates at MCLP's levels should be financially workable for SBC-MV.

B. Government Network

The current franchise requires MCLP to operate a government network ("G-Net") for the County. The County depends on this network to serve vital County needs on a day-to-day basis. However, the present G-Net faces two major problems: capacity and reliability. The G-Net is at the limit of its capacity for the County's present needs. Yet over the life of the MCLP franchise, for a variety of reasons, it has proven extremely difficult to maintain the G-Net's performance and maintain its technical specifications. Only after major maintenance this year did MCLP bring the government network into compliance with acceptable test parameters on July 29, 1993. The G-Net requires continuing efforts by the cable operator to maintain its proper operation.

To rebuild the G-Net with a newer technology, MCLP has agreed to provide the County with \$6.0 million dollars. The County's technical analysis indicates that this sum should be sufficient for the County's near-term needs.

C. New Services

SBC-MV has provided statements outlining new services that might, at some future time, be offered on a system under SBC-MV's control. SBC-MV has made it clear that it is making no commitments to any particular upgrade or improvement of the system at any time. However, the County anticipates that SBC-MV will move reasonably quickly to construct an upgraded fiber optic network in the County. See Attachment 2.

1. The Settlement Agreement Provides Guaranteed Access to Any New Facilities

If and when SBC-MV installs a fiber optic network, it has agreed to make available to the County, free of charge, transmission capacity on up to 300 linear plant miles of that network. The County will have the right to use up to ten percent of the transmission capacity, deployed on two fibers to a maximum of 4.8 gigabits per second at any point on the network. SBC-MV has agreed to consult and cooperate with the County on the timing and routing of such new facilities. SBC-MV will be responsible for construction, operation, network management and maintenance of the facilities interconnecting the SBC-MV network to locations designated by the County, at no cost to the County. These Settlement Agreement provisions concerning new services adequately compensate the County for the risks involved in the implementation of new technologies.

2. Effect of the Modification of Final Judgement

If and when SBC-MV wishes to offer advanced services, it must comply with restrictions contained in the Modification of Final Judgement ("MFJ"), the 1982 court decision governing the activities of the Regional Bell Operating Companies ("RBOCs") subsequent to the AT&T breakup. Among other things, the MFJ prohibits a RBOC, such as Southwestern Bell Corporation, or any of its subsidiaries, such as SBC-MV, from providing interexchange (long distance) services. If the transfer application is approved, SBC-MV will be involved in two types of interexchange services: (1) the reception of satellite signals at the cable's headend, and (2) the transmission of cable signals across a telephone local access transport area (LATA) boundary line that divides a small section of northwestern Montgomery County (lying in the "Hagerstown LATA") from the rest of the County (lying in the "Washington, D.C. LATA") for interexchange purposes.

Accordingly, SBC applied for a federal court waiver of the MFJ restriction on behalf of SBC-MV to allow it to take over MCLP's current service. SBC received this waiver from the Court on September 21, 1993. The waiver is specifically limited to

provision of traditional cable service. Other sorts of service, such as advanced two-way services or the services now provided on the G-Net, are not covered by the waiver. This means that if SBC-MV wished to provide a non-traditional cable service on the subscriber network in the Hagerstown LATA area, it would need to get an additional MFJ waiver from the court, since such service would extend outside the Washington, D.C. LATA to the Hagerstown LATA. SBC-MV would also need an additional waiver if the County wished to extend the G-Net into the Hagerstown LATA area. MCLP, in contrast, would not have to obtain such a waiver; it is not a telephone company and hence is not subject to the MFJ. The effect of this distinction is that SBC-MV may face some additional regulatory hurdles that MCLP would not, if and when it moves to offer advanced services on a network extending into the Hagerstown LATA.

D. Franchise fees

The Agreement granting a cable franchise to MCLP as modified on Nov. 14, 1986 ("Franchise Agreement"), and the County's Cable Communications Law, Montgomery County Code 1984, Chapter 8A ("Cable Communications Law"), require that MCLP pay a franchise fee of five percent, together with an access grant of 1.5 percent, on all gross revenues from the operation of the cable system within the franchise area. See Cable Communications Law, § 8A-12(a); Franchise Agreement §§ 37(A), 31(I)(E)(2)(a). This provision makes no distinction between traditional cable service and other types of services that might be offered over the cable system. Thus, in order to approve the transfer of the system, the County requires that SBC-MV acknowledge that franchise fees are due on all gross revenues derived from non-cable services as well as from cable service.

SBC-MV has stated in the Settlement Agreement that it accepts the applicable franchise fee provisions of the Franchise Agreement and the Cable Communications Law. Consequently, SBC-MV has agreed to pay a five percent franchise fee and a 1.5 percent access grant on all gross revenues of SBC-MV or of any affiliate, derived from the operation of the cable system within the franchise area insofar as such payments are consistent with the Franchise Agreement and the County Cable Communications Law, during the period of the franchise.

E. Differences in Experience and Management Accessibility

Even though SBC-MV has limited experience in cable, its extensive experience in the telephone industry indicates that it is able to efficiently and effectively run a telecommunications system. SBC's experience in the cable field in Great Britain provides support for this conclusion. The County Executive

believes that SBC's experience and resources will enable SBC-MV to provide the same high quality of service to the County's subscribers as it provides to its other customers.

SBC's large corporate structure may result in the County receiving less individual attention from SBC's management than it does from MCLP. However, the County will benefit from the depth of financial and technical resources available to SBC, which would not be available to MCLP.

III. The County Has Authority to Approve or Deny the Transfer.

Before MCLP can transfer to another party the franchise the County granted to MCLP, it must obtain the County's approval. The County has the right to approve or deny such a transfer based specifically on the terms of the County's Cable Communications Law and the franchise agreement between the County and MCLP. Neither the 1992 Cable Act, nor the FCC regulations promulgated thereunder, prevent the County from determining whether the proposed transfer is acceptable.

Section 8A-23(e) of the Cable Communications Law states:

Before approving transfer of a franchise, the County must consider the legal, financial, technical and character qualifications of the transferee to operate the system, and whether operation by the proposed franchisee will adversely affect the cable services to subscribers or otherwise be contrary to the public interest.

The County has the right and responsibility to protect the public interest by evaluating any proposed transfer according to these considerations.

The Franchise Agreement expressly incorporates by reference the requirements of the County's Cable Communications Law, as amended. Franchise Agreement at § 6. Thus, by its acceptance of the Franchise Agreement, MCLP has agreed to the County's right to approve or deny a transfer, as set forth in the Cable Communications Law. In addition, the Franchise Agreement requires that SBC-MV be bound by all the provisions, terms, conditions, obligations, and limitations of the existing franchise. Id. at § 16(D).

The 1992 Cable Act does not alter the fundamental authority of the County to approve or disapprove a transfer. The Cable Act places no conditions on the criteria a franchising authority may apply in determining whether to approve a proposed transfer. Nor does it grant the FCC any authority to limit those criteria.

Similarly, the FCC's rules implementing the 1992 Cable Act do not attempt to limit the reasons for which a franchising authority may accept or reject a transfer proposal. Nor do the FCC's rate regulation rules restrict the County's rights with respect to a transfer.

IV. Conclusion

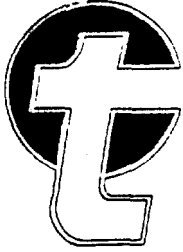
The County Executive has determined that a transfer of the Montgomery County cable franchise to SBC-MV, subject to the terms and conditions embodied in the Settlement Agreement, would be in the best interests of the County and its residents. Operation of the system by SBC-MV will not adversely affect subscriber cable services or otherwise be contrary to the public interest. Therefore, the County Executive recommends that the Council approve the proposed transfer, subject to the provisions of the Settlement Agreement, for the following reasons.

- SBC-MV has adequately demonstrated the financial, legal, technical, and character qualifications to manage and operate the system.
- SBC-MV is willing to accept all MCLP's obligations under the current franchise, including payment of franchise fees on all revenues earned from the operation of the system.
- Subscriber rates will not be adversely affected by the transfer for at least three years.
- The County is assured of needed improvements in the G-Net system.
- The County gains potential benefits in the form of preferred customer access to new services, if and when SBC-MV introduces an improved system to provide such services.

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Attachments

1. Columbia Telecommunications trip report
2. SBC-MV's outlook regarding new services
3. Settlement Agreement
4. Survey of local cable rates
5. Financial analysis documents
6. Industry comparison chart
7. SBC-MV pro forma projections



Columbia Telecommunications Corporation

Telecommunication System Engineers

MEMORANDUM

DATE: July 29, 1993

TO: Robert P. Hunnicutt,
Office of Consumer Affairs

FROM: Lee Afflerbach *Lee Afflerbach*
Columbia Telecommunications Corporation

SUBJECT: UK FACILITIES INSPECTION TRIP

Southwestern Bell Corporation (SBC) has granted seven separate franchises to operate cable systems in the UK. We visited the headend for the Black Country franchise, named due to its location in the old, heavy industrial areas, west of the City of Birmingham for purposes of inspecting the SBC operations and facilities. The Black Country franchise has potentially over 500,000 residential units and currently 63,000 residence have been passed by SBC. The system is served from a common headend in the community of Wigan located approximately 20 miles west of the City of Birmingham. The cable system consists of a newly designed fiber to feeder architecture system. The cable system has been designed such that fiber optic cable is provided from the headend throughout the neighborhood through a common feed point which services 80 homes or less. This high density of fiber is primarily used to provide telephone services to subscribers. This system installed by SBC is capable of providing both CATV and conventional telephone services to subscribers. They currently have a mixed SBC as a mix of telephone/cable subscribers, cable only, and telephone only subscribers. Their telephone system is in direct competition with British Telcomm, the national telephone service provider.

All of the CATV equipment installed by SBC is of design and consistent with the most modern cable implementation in this country. There are slight variations due to the fact that the differing transmission standard (PAL vs. NTSC) is used in the UK, and due to the fact that there are a far lesser number of off-the-air and satellite services available in the UK market.

The headend has sufficient capability to provide approximately 60 channels to subscribers. Currently, there are only 36 channels provided to subscribers. This is mainly due to lack of available programming and materials from the normal satellite sources. The lack of programming stems from both the inability to obtain signals and copyright restrictions held by the DBS (Direct Satellite Broadcast) competitors.

The system contains a modern headend capable of supporting over 60 channels. There is, at present, no local production equipment nor any local programming provided by any government or nonprofit organization. The company is not involved in production of any local programming.

At present, SBC is providing not only single line telephone services, but additionally, interconnection between telephone switches and specialized point-to-point and multi-drop circuits for a variety of business, voice, and data communications applications.

We found that the significant effort has been placed in planning the overall system to the minutest detail. Comprehensive maps were available for the design and installation data on the entire system. All of the facilities examined including the headend, the telephone communications switching room, the transmission conduit, and the neighborhood distribution plant and facilities were found to be of the highest quality. It should be noted that all construction in the UK is underground construction and, therefore, requires the placement of conduit for all cable plants. In each of the neighborhoods, individual telephone type cabinets are used to interconnect both telephone and CATV subscribers to the transmission plant.

The SBC system includes an extensive network oversight system for both the CATV and the telephone network. Backup power is provided at the headend, along the plant, and to all active components. The technical performance standards of the SBC cable TV system greatly exceed the Montgomery County standards and the operation value of the existing CTM system. The SBC engineers emphasized the importance of high reliability, low maintenance network. The focus on network reliability related both to customer satisfaction and to minimizing labor costs for system maintenance and operation.

Based on my knowledge of current cable construction practices in the U.S. and the information gained from this trip, I believe it is reasonable to assume that a system much like the UK system will eventually be implemented in Montgomery County. Such a system will allow SBC to improve performance in the form of picture quality, channel capacity, and system reliability. Further, it will allow SBC to offer other telecommunications services such as data transmission services, commercial video and telephone interconnect services.

Section 5

SBC-MV intends to meet the cable-related needs and interests of the community by continuing to maintain and operate a quality cable network and offering high-quality customer services. Few changes are planned for the well-run organization following the acquisition. The system is intended to operate under SBC-MV's direction with maximum autonomy to respond to customer and community needs. New technologies will be implemented in the system as economically and technically feasible.

SBC-MV is committed to providing high-quality customer services. Major strategic initiatives are:

Accelerated Consumer Acceptance of Products and Services

- meet or exceed customer's service expectations
- increase customer awareness of product lines

Maintain the Infrastructure on Which to Grow the Business

- maintain and extend a cost-effective, quality broadband network capable of providing current and future products and services
- enhance relationships with key local and minority suppliers
- develop corporate culture that breeds and rewards excellence

Establish an Exemplary Company Image/Reputation

- continue to assume leadership role in the industry and community
- attract, retain and develop highly-motivated, competent employees

An example of Southwestern Bell's customer orientation is the establishment by Southwestern Bell Mobile Systems of a customer certification program for technicians installing cellular service. These Certified Southwestern Bell Mobile Systems Technicians must complete advanced training courses. They undergo frequent on-the-job reviews, demonstrate high standards in all phases of their work, and maintain proven records of accomplishment in the cellular field. The same attention to customer service and technician qualifications will be applied to the cable television operation.